



Households During the Great Recession: The Financial Accelerator in Action?

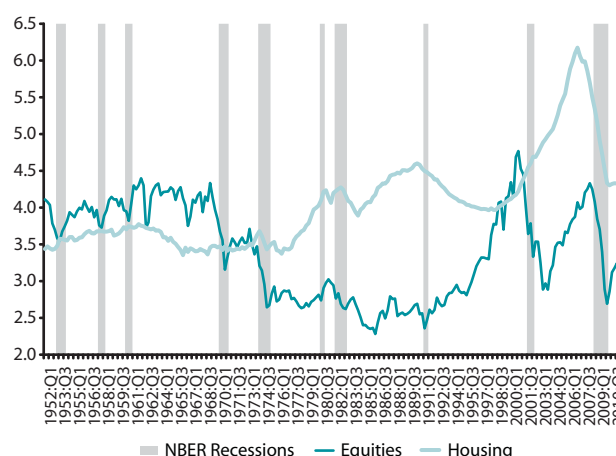
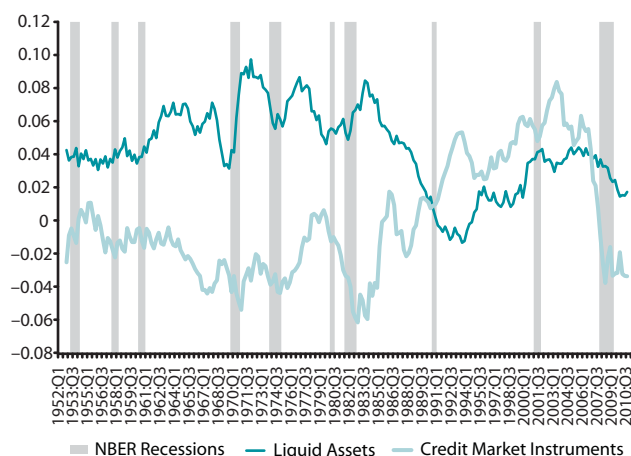
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During the recent financial crisis the Federal Reserve lowered interest rates to near zero. Later it implemented two rounds of quantitative easing and created lending facilities to support the financial system. These policies were designed in part to attenuate the negative implications of the financial accelerator mechanism whereby malfunctioning credit markets “are not simply passive reflections of a declining real economy, but are in themselves a major factor depressing economic activity.”¹

One way the financial accelerator can affect individual households is as follows: Lenders’ monitoring costs must be passed on to borrowers and result in a premium on borrowing rates. The size of the premium varies negatively with the net worth and overall financial position of the borrower. Hence, any shock that affects a household’s financial position also affects its borrowing capacity. In turn, lower borrowing capacity may depress household spending, economic activity, and, ultimately, asset values. The resulting vicious cycle accelerates the impact of negative economic shocks.

Households are the sector that the financial accelerator appears to have hit hardest, according to the data.

Here, I use U.S. household time-series data to determine whether periods of financial distress are associated with lower credit availability and depressed asset values, as implied by the financial accelerator mechanism. The chart on the left displays net changes in household holdings of credit market instruments (debt) and liquid assets as ratios to total consumption expenditure. Until the early 1980s, households were lowering their debt and accumulating liquid assets at a rate equivalent to 3 percent and 6 percent of aggregate consumption, respectively, on a yearly basis. Around 1986, households started accumulating debt and eroding their liquid asset holdings. By 2007, households were increasing debt at a rate equivalent to 6 percent of aggregate consumption every year. Accumulation of liquid asset holdings restarted around the mid-1990s.



NOTE: Left chart, net changes in household credit and liquid asset holdings. Right chart, household equity and housing wealth. Both are expressed as ratios to consumption expenditure. NBER, National Bureau of Economic Research.

SOURCE: Federal Reserve Statistical Release Z.1 (Flow of Funds Accounts) and Bureau of Economic Analysis (National Income and Product Accounts).

The financial crisis of 2008 resulted in the largest deleveraging observed in the sample period. Debt accumulation plummeted from 6 percent to –4 percent of aggregate consumption. Liquid asset holdings declined by almost a factor of two as well. Furthermore, as shown in the chart on the right, the financial crisis coincided with the largest simultaneous declines in the value of housing and equities in the sample period, substantially eroding households' wealth and financial positions. Durable consumption (not shown) was also substantially affected: By the first quarter of 2011, it stood 25 percent below the trend implied by 1990-2006 data.

Households are the sector that the financial accelerator appears to have hit hardest, according to the data. As shown in the previous issue,² credit availability for the business sector was apparently no different than in previous recessions, which suggests that either the negative accelerator effects are not as important for businesses or they were counteracted by existing policies. ■

¹ Bernanke, Ben S.; Gertler, Mark and Gilchrist, Simon. "The Financial Accelerator in a Quantitative Business Cycle Framework," in John B. Taylor and Michael Woodford, eds., *Handbook of Macroeconomics*. Chap. 21. Amsterdam: Elsevier, pp. 1341-393.

² Peralta-Alva, Adrian. "Searching for the Financial Accelerator: How Credit Affects the Business Cycle." Federal Reserve Bank of St. Louis *Monetary Trends*, September 2011; <http://research.stlouisfed.org/publications/mt/20110901/cover.pdf>.